

Message Text

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SUBJ: FINANCIAL MARKETS COMMITTEE MEETING, JULY 10-11

1. REF CFM AGENDA ITEM 4. US MONETARY POLICY MUST RESPOND TO ONGOING ECONOMIC DEVELOPMENTS AND CANNOT BE FORECAST. HOWEVER, ONE IMPORTANT OBJECTIVE OF POLICY HAS BEEN TO KEEP MONETARY GROWTH TO MODERATE DIMENSIONS, AND IT IS THIS THAT HAS NECESSITATED HIGHER INTEREST RATES OVER RECENT MONTHS. IF EXPANSION IN GNP SLOWS, AS EXPECTED, MODERATE MONETARY GROWTH MAY NOT BE TOO DIFFICULT TO ACHIEVE, AND IN THIS EVENT SHORT-TERM RATES COULD NOW BE AT OR APPROACHING THEIR PEAKS. BUT IF RAPID GNP EXPANSION PERSISTS, WHETHER DUE TO INFLATION OR TO RISING REAL OUTPUT, ADHERENCE TO THE TARGET OF MODERATE MONETARY GROWTH MIGHT WELL IMPLY STILL HIGHER INTEREST RATES TO COME.

2. SHORT -TERM INTEREST RATES HAVE INCREASED SHARPLY FURTHER SINCE MAY, WITH FEDERAL FUNDS RATE NOW APPROACHING 10 PERCENT AND 3-MONTH TREASURY BILLS AT 8 PER CENT. AS A
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RESULT OF THESE HIGH MARKET RATES, THE FLOW OF SAVINGS HAS

BEEN SHIFTING AWAY FROM THE DEPOSITARY INSTITUTIONS INTO DIRECT SECURITIES INVESTMENT. ACCORDINGLY, THE AUTHORITIES LAST WEEK RAISED THE CEILING RATES THAT MAY BE PAID BY INSTITUTIONS TO INDIVIDUAL SAVERS, TO AS HIGH AS 6.75 PER CENT, AND SUSPENDED CEILING RATES ALTOGETHER FOR CONSUMER TIME DEPOSITS WITH A MATURITY OF 4 YEARS OR MORE. HOPE IS THAT THIS WILL PERMIT INSTITUTIONS TO COMPETE MORE EFFECTIVELY FOR FUNDS AND THEREBY SUSTAIN THE FLOW OF MORTGAGE CREDIT, THOUGH UNDOUBTEDLY AT A HIGHER LEVEL OF RATES. FHA-VA MORTGAGE MAXIMUM INTEREST RATES WERE ALSO RAISED LAST WEEK, TO 7.75 PER CENT.

3. UNTIL VERY RECENTLY, LONG-TERM INTEREST RATES HAD NOT RESPONDED SIGNIFICANTLY TO HIGHER RATES IN THE SHORT-TERM SECTOR. ISSUANCE OF NEW LONG-TERM SECURITIES HAS BEEN QUITE MODERATE IN VOLUME, AND THE SUPPLY OF INVESTMENT FUNDS AT WHAT ARE HISTORICALLY RELATIVELY ATTRACTIVE YIELDS HAS BEEN ADEQUATE. IN RECENT DAYS, HOWEVER, THE FURTHER TIGHTENING IN MONEY MARKET CONDITIONS HAS PUT SHORT-TERM RATES ABOVE THOSE PREVAILING IN THE LONG-TERM MARKET, AND LONG-TERM YIELDS HAVE BEEN ADJUSTING UPWARD. EVEN ASSUMING NO FURTHER RISE IN SHORT-TERM RATES, SOME FURTHER ADJUSTMENT IN LONG-TERM RATES SEEMS PROBABLE. BORROWERS MAY NOW TEND TO SHIFT TO LONGER-TERM BORROWING, WHILE INVESTORS WILL BE INCLINED TO ACQUIRE SHORTER-TERM SECURITIES AT THEIR MORE ATTRACTIVE RATES. THE MORTGAGE MARKET, WHERE DEMANDS FOR CREDIT REMAIN STRONG AND WHERE LENDER COSTS HAVE BEEN INCREASED BY THE RATE CEILING ACTION, APPEARS PARTICULARLY EXPOSED TO HIGHER RATES AND MORE RESTRICTIVE LENDING TERMS. BUT THE PROSPECT OF RATE ESCALATION IN CREDIT MARKETS GENERALLY SHOULD NOT BE EXAGGERATED. A MAJOR FACTOR TENDING TO RELIEVE RATE PRESSURE IS THE IMMEDIATE PROSPECT OF A MUCH SMALLER FEDERAL DEFICIT, ESTIMATED AT ONLY \$2.7 BILLION IN THE FISCAL YEAR THAT HAS JUST BEGUN. CONSUMER SPENDING HAS SHOWN SIGNS OF MODERATION, TOO, AND THIS SHOULD REDUCE THE DEMAND FOR INSTALLMENT CREDIT. FINALLY, BUSINESS CORPORATIONS HAVE HAD A LARGE INCREASE IN PROFITS AND OTHER INTERNALLY GENERATED FUNDS, AND HAVE THUS FAR MET THEIR NEEDS FOR EXTERNAL FINANCE LARGELY THROUGH SHORT-TERM

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